IN THE

# Supreme Court of the United States

OCTOBER TERM, 1926.

No. 289

THE UNITED STATES,
*Petitioner,*

*v.*

CHARLES A. LUDEY.

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS.

## BRIEF FOR RESPONDENT.

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### Opinion of the Court Below.

The opinion of the Court of Claims is found on pages 14 to 20, inclusive, of the transcript. It is reported in 61 C. Cls. 126.

### Grounds of Jurisdiction.

The judgment to be reviewed was entered by the Court of Claims on November 9, 1925 (R. 10). A petition for certiorari was filed February 4, 1926 (R. 20). It was granted by this Court April 19, 1926 (271 U. S. 651), under Section 3 (b) of the Act of February 13, 1925 (c. 229, 43 Stat. 936, 939).

## The Question Involved.

Counsel for the respondent believes the following to be a fair statement of the question here presented:

In determining the amount of gain or loss resulting from the sale of an oil producing property, should the original cost of such property be reduced in any amount (or the sales price be increased) by reason of the extraction and sale of oil, or by reason of exhaustion, wear and tear during the period of ownership; or stated differently:

Are the proceeds from mining and oil operations, after the deduction of expenses and losses, but without a deduction of so-called depletion and depreciation, income or in part a return of capital?

## The Statutes.

Title I, Act of September 8, 1916 (Chap. 463, 39 Stat. 756), as amended by the Act of October 3, 1917 (Chap. 63, 40 Stat. 300, 329), provides:

> Sec. 1 (a) That there shall be levied, assessed, collected, and paid annually upon the entire net income received in the preceding calendar year from all sources by every individual, a citizen or resident of the United States, a tax of two per centum upon such income * * *

> Sec. 2 (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income, derived from salaries, * * * or dealings in property, whether real or personal, grow-

ing out of the ownership or use of or interest in real or personal property.

* * * * * *

(c) For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived.

Sec. 5. * * *

(a) For the purpose of the tax there shall be allowed as deductions—

* * * * * *

Fourth. Losses actually sustained during the year, incurred in his business or trade, * * *: Provided, That for the purpose of ascertaining the loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such loss sustained;

## Statement of the Case.

The properties here involved are fees and leaseholds.

"The Pitman fee was purchased by plaintiff in February, 1915, for $3,000, was sold by him in 1917 for $4,500, a gain of $1,500. * * *" (R. 11, Finding IV, sixth paragraph.)

It is found as a fact by the Court, (R. 11, Finding IV, third, fourth and fifth paragraphs) that

> "The fee to said Goodman farm and said Matney lease were purchased by plaintiff in 1911 * * *.
> Said Wolfe lease was purchased by plaintiff in July, 1913 * * *.
> Said Billingslea lease was purchased by plaintiff in December, 1913 * * *.

It is also found as a fact that

> "The Goodman fee, Matney lease, Wolfe lease and Billingslea lease were sold by plain[illegible] in February, 1917." (R. 11, Finding IV, last paragraph, page 11, and second paragraph page 12.)

The Court therefore found that the property purchased and the property sold was identical property, fees and leaseholds.

**Statements of Fact in Petitioner's Brief.**

Counsel desires to correct certain inadvertent inaccuracies which appear in the petitioner's statement of the case.

On pages 4 and 5 of his brief, the petitioner concisely and accurately explains the nature of the suit, describes the property purchased and sold, and states the cost thereof to the respondent.

Exception must be taken, however, to the statement as of fact on page 6, that while the respondent held the properties in question he "operated them and extracted from the oil reserves certain quantities of oil which depleted the oil reserves in the sum of $32,253.81". The cited reference to the record (R. 12 Finding V) does not sustain the con-

clusion. The finding referred to is that "depletion was sustained upon said properties in the sum of $32,253.81 * * * *according to the method of computation employed by the Bureau of Internal Revenue.*" The distinction here made is not a quibble, but a point of importance in respondent's view of the case. It is not found as a fact, and the respondent does not admit, that there was any such depletion or decrease of oil reserves. It is found as a fact, and of course not denied, that certain oil was extracted from the properties. But manifestly, in the nature of the case, it is unknown, and impossible of human determination, how much oil was recoverable when the respondent acquired the properties or when he disposed of them and, therefore, it cannot be found or stated as a fact how much, or indeed, if any depletion was actually sustained.

A similar exception is taken to the statement on pages 6 and 7 of petitioner's brief that "the physical equipment and improvements on the properties were depreciated in the sum of $10,465.16". This figure was also found "according to the method of computation employed by the Bureau of Internal Revenue" (R. p. 12).

Throughout his statement of the facts and as well throughout the entire brief the learned Solicitor General appears to consider as established and agreed that the oil content of the properties was actually and definitely depleted and that the physical equipment and improvements actually and definitely depreciated while in the ownership of the respondent. Thus on page 12 of his brief he states, "During the period of his ownership, the taxpayer reduced to his possession and ownership oil which at the well (Art. 142, Reg. 33, T. D. 1944, Appendix) represented a cost to him of $32,253.81 (R. 12, Finding V.)". Counsel has

pointed out that nothing in the record justifies the statement that depletion was sustained and it is difficult to apprehend whether the Solicitor General is relying on Finding V for his statement or on Art. 142 of Reg. 33, T. D. 1944, which was rejected by this court in *Goldfield Consolidated Mines Company* v. *Scott*, 247 U. S., 126, insofar as depletion and depreciation was considered a return of cost or capital.

The persistence of this error calls for emphasis on its correction. Thus on page 19 of the petitioner's brief it is said:

> "Disregarding any supposed legal theory, the respondent in fact purchased an oil reserve of so many barrels. (R. 11, Finding IV.) Likewise when he sold, the price he received was based upon the number of barrels estimated to be in the reserve at the time of sale."

This statement is not supported by the finding of the court below (R. 12, Finding IV), nor is it consistent with the Solicitor General's own statement of the case on page 8 of his brief, as follows:

> "The price obtained for the Goodman fee, the Matney lease, the Wolfe lease and the Billingslea lease was allocated on the basis of the *daily production* of the four properties, *which is the basis on which they were sold* (R. 12)."

It is desired, before entering the argument, to emphasize that the respondent does not agree, but on the contrary denies, that the properties in question were actually depleted or depreciated, or in any degree changed in character, while in the ownership of the respondent.

## Summary of Argument.

The respondent sold capital assets at a price less than their cost or fair market value and thereby suffered an actual loss.

The increase of taxable gain in the year of sale of a capital asset by reducing the actual cost, by such amounts as the Government deems to represent depletion or depreciation of prior years, results directly in taxing capital in the amount that actual cost exceeds the basis used by the Government.

The proceeds from mining and oil operations in excess of expenses and losses are *income* and not in part a return of capital. The law could not be otherwise, because of the nature of mining and oil properties. Discovery and development may outrun depletion. Oil has no fixed situs under a particular portion of the earth's surface. It has the power of self transmission and that which is in one's property today may move or be drawn into another's tomorrow. There is no ownership of oil until it is actually reduced to possession. The only right an owner or lessee has is the right to prospect for and reduce to possession. The exhaustion of a natural deposit may be deferred over a long term of years and may never entirely occur. It is repugnant to reason and to the facts to say that the proceeds from mining operations over expenses and losses are anything other than income. It may be true in certain cases as this court has observed, that the operation of the deposit serves to exhaust it in a measure and that the proceeds of the operation include a modicum of capital; but this court has also held that that fact is contemplated when the investment is made, the modicum of the capital that may be

included in the proceeds is not of sufficient importance to be taken into account.

The purchase of an "oil reserve" is not the purchase of a certain number of barrels of oil. The phrase, "oil reserve", properly refers to the character of the property, the right to take whatever oil may be obtained from it, and does not refer to or describe an inert body of oil of unchanged quantity except as lessened by extraction. An "oil reserve" is not a reservoir or tank of oil.

The properties purchased and sold were fees and leaseholds. These properties did not change "in character". The extraction, refining and sale of oil were not part of the transaction of purchase and sale of the fees and leaseholds. The proceeds from operation were annual gains returned and taxed according to the laws in effect during the years the proceeds were earned. After a tree has borne fruit, it is none the less a tree. And even if the property had changed in character between the dates of purchase and sale, a gain or loss would have resulted, measured by the difference between the cost and sale price.

The action of the petitioner increases the taxable gain on the sale by reducing the cost in such amounts as the government deems to represent depletion or depreciation of prior years. *Thus it directly taxes capital in the amount that cost exceeds the basis used by the Government.* Such action also in effect denies to the respondent previous annual deductions granted by Congress and mulcts him by the difference between the extremely high rates in 1917 and the very low rates in effect from 1913 to 1917.

The government proposes to read something into the statute which is not there, to graft something on it, to read it loosely instead of strictly, to tax by implication, and to resolve all doubts in favor of the government.

Clearly, the proceeds from mining operations in excess of expenses and loss are earnings,—income. In the sale of a fee or leasehold to mining properties the cost should not be reduced, thereby fictitiously increasing the gain in the year sold, by any amount received from operations.

## Argument.

The United States has here taxed such part of *the proceeds realized upon the sale of an oil property* as represents the amount of so-called depletion and depreciation which it claims was theretofore sustained, contending that the respondent had by virtue of such depletion and depreciation recouped from operations a part of the capital originally invested.

The respondent submits that the increase of taxable gain in the year of sale of capital assets by reducing the actual cost in the amount of so-called depletion and depreciation of prior years results in a direct tax, a tax on capital and not on income, because the proceeds of operations denominated depletion and depreciation are not returns of capital, but are earnings as this court has held. The reduction of the cost by such amounts subjects to tax a part of the cost. Thus the question may be stated:

### Are the Proceeds From Mining and Oil Operations Income or in Part a Return of Capital?

If such proceeds are income, the decision should be for the respondent, but if they are in part a return of capital, the decision should be for the petitioner.

The petitioner in its brief has begged the question. It has *assumed* as its premise that so-called depletion and depreciation are a return of capital.

This court has held otherwise and passed squarely upon the question in the case of *Goldfield Consolidated Mines Company* v. *Scott*, 247 U. S. 126. In that case the Circuit Court of Appeals for the Ninth Circuit certified these two questions for decision, page 130, as follows:

> "The questions propounded are:
>
> '1. Under the provisions of paragraph 38 of the Act of Congress * * * approved August 5th, 1909, * * * is a mining corporation, for the purpose of determining its net income for the basis of taxation, entitled to deduct from its gross income *any amount whatever** on account of depletion or exhaustion of ore bodies caused by its operations for the year for which the tax is assessed?
>
> '2. Is such a corporation under said Act, entitled in the ascertainment of its net income, to a deduction against gross proceeds from the mining and treatment of ores *to the extent of the cost value* of the ore in the ground before it was mined, ascertained in strict compliance with the rules and regulations of the Treasury Department of February 14th, 1911 (T. D. 1675)?

These questions are direct, unequivocal and unambiguous. Clearly, if such a deduction were a return of capital, such a corporation would be entitled to it. The answer of this court was likewise direct, unequivocal and unambiguous, as follows:

> "In view of the discussion of the nature of mining property in Stratton's Independence *v.* Howbert, *supra,* and the application of the principles therein laid down in the subsequent cases of Stanton v. Baltic Mining Co., 240 U. S. 103, and Von Baumbach *v.*

* (Italics, where used, are ours unless otherwise noted.)

Sargent Land Co., *supra,* it is unnecessary to enter upon further consideration of the matters disposed of in those cases. We find no occasion to depart from the principles therein announced, or the rulings therein made. They have been reaffirmed in the case of United States *v.* Biwabik Mining Co., *ante,* 116. In this view it follows that *the first and second questions must be answered in the negative,* and that it is unnecessary to answer the third and fourth questions."

This court had previously held in *Stratton's Independence* v. *Howbert,* 231 U. S. 399, that deduction for the exhaustion of the ore body did not constitute depreciation; in *Stanton* v. *Baltic Mining Company,* 240 U. S. 103, that the denial of a deduction for the exhaustion of the ore body and the taxation of the proceeds thereof was not a tax on capital; and there was no question of a loss involved. Therefore, the proceeds from mining operations can be nothing but income, and this court has so held, and *has held those proceeds taxable as income.* " 'Income' has been taken to mean the same thing as used in the Corporation Excise Tax Act of (August 5), 1909 (36 Stat. at L. 11, chap. 6), in the 16th Amendment and in the various revenue acts subsequently passed." *Bowers* v. *Kerbaugh-Empire Company, decided May 3, 1926,* 271 U. S. 518; *Southern P. Co.* v. *Lowe,* 247 U. S. 330, 335; *Merchants' Loan & T. Co.* v. *Smietanka,* 255 U. S. 509, 519.

Counsel submits that the above decisions are entirely conclusive upon the issue here presented.

*Lynch* v. *Alworth-Stephens Co.,* 267 U. S. 364, merely holds that the lessee of a mining property is entitled to his proportionate share of *a statutory deduction* for deple-

tion; it does not alter, but on the contrary, reaffirms, the long established rule of this court, that in determining income no allowance need be made for depletion in the absence of statutory provision therefor, and that the returns from mining properties are in fact income and not capital.

The Pennsylvania courts have passed on questions such as this one many times. Oil was first discovered in Pennsylvania and this court has always given great weight to decisions of that state on questions concerning natural resources. *Ohio Oil Co.* v. *Indiana*, 177 U. S. 190. In the case of *Commonwealth* v. *The Ocean Oil Co.*, 59 Penna. St. 61, Pennsylvania had levied a tax of 3 per centum upon *the net income* of corporations. The Ocean Oil Co. resisted the assessment contending that the proceeds from the operation of oil properties in excess of expenses were a return of capital. The lower court held that there should be a deduction for a return of capital measured by so much of the annual product as would repay the capital in the probable number of years that oil would flow or be taken from the land and that only the excess of the proceeds over expenses and the aliquot deduction for return of capital constituted "net income" subject to tax, just as the Government has done in the case at bar. The Supreme Court of Pennsylvania rejected the opinion of the lower court and held, page 63:

> "The question therefore is, what is the meaning of 'net earnings or income'? Does it mean, as it was construed by the treasurer in his report to the auditor-general, the product of the business after deducting expenses only? If so, then the settlement by the auditor-general and state treasurer is correct.

But it is contended by the company, that the annual product must first be applied to the repayment of capital, and this would leave no net earnings or income to tax. The court below compromised between these two constructions, and held that there must be an application of so much of the annual product, as would repay the capital, in the probable number of years that oil would flow or be taken from the land, and then the surplus would be the net earnings or income subject to taxation. This mode requires the interposition of a jury wherever there is a difference of opinion between the company and the state authorities.

I can see no warrant for such a reading of the law. * * * * *

See also same decision by same court on same questions where the operations were for coal. *Commonwealth* v. *The Penn Gas Coal Co.*, 62 Penna St. 241.

The decisions of the English courts and the state courts of this country are in accord with the above cited decisions, holding that a mining corporation "like any other corporation organized for the purpose of utilizing a wasting property,—a property that can be used only by consuming it,—as a mine, a lease, or a patent, is not deemed to have divided its capital merely because it has distributed the net proceeds of its mining operations, although the necessary result is that so much has been subtracted from the substance of its estate. Mor. Priv. Corp., §442, *Lee* v. *Neuchatel Asphalte Company*, 41 Ch. Div. 24." *Excelsior Water & Mining Company* v. *Pierce*, 90 Cal. 131, 27 Pac. 44; *People ex rel. United Verde Copper Company* v. *Roberts*, 156 N. Y. 585, 51 N. E. 293; *Mellon* v. *Mississippi Wire Glass Company*, 77 N. J. E. 498, 78 Atl. 710; *Van Vleet* v.

*Evangeline Oil Co.*, 129 La. 406, 56 Southern 343; *Boothe* v. *Summit Coal Mining Co.*, 55 Wash. 167; 104 Pac. 207; and Sec. 34 of Chap. 65 of the Revised Code of Delaware as amended, Mar. 2, 1927.

The text writers are uniformly to the same effect. Morawetz Private Corporations, Section 442, page 415; Clark & Marshall on Private Corporations, Volume 2, page 1593; Thompson's Commentaries on the Law of Private Corporations, page 111; Cook on Private Corporations, Volume 2, page 1903; Encyclopedia of Law and Procedure, Volume 10, page 553 (1904); Corpus Juris, Volume 14, page 802 (1919); Fletcher's Cyc. of the Law of Private Corporations (1919), Sec. 3670, page 6104.

**The Decisions Could Not Be Otherwise Because of the Nature of Mining and Oil Properties.**

This court has held that oil is fugacious, has the power of self-transmission, moves from place to place, and that which is in one person's property today may move or be drawn into another's tomorrow. This being true, it may not be said that so-called depletion of the capital invested in an enterprise is effected when a certain number of barrels of oil are removed from one's property. One of the leading cases to this effect is *Brown* v. *Spilman*, 155 U. S. 665, 669, wherein this court said:

> "Petroleum gas and oil are substances of a peculiar character, and decisions in ordinary cases of mining, for coal and other minerals which have a fixed *situs*, cannot be applied to contracts concerning them without some qualifications. They belong to the owner of the land, and are part of it, so long as they are on it or in it, or subject to his control, but when they escape and go into other land, or come under

another's control, the title of the former owner is gone. If an adjoining owner drills his own land and taps a deposit of oil or gas, extending under his neighbor's field, so that it comes into his well, it becomes his property. Brown *v.* Vandergrift, 80 Penn. St. 142, 147; Westmoreland Nat. Gas Co.'s Appeal, 25 Weekly Notes of Cases, (Penn.), 103."

And the later leading cases of *Ohio Oil Company* v. *Indiana*, 177 U. S. 190; *Lindsley* v. *Natural Carbonic Gas Company*, 220 U. S. 61; *West* v. *Kansas Natural Gas Co.*, 221 U. S. 229; *Walls* v. *Midland Carbon Co.*, 254 U. S. 300; *Rich* v. *Doneghey* (Okla.) 177 Pac. 86, 89; *Lindlay* v. *Raydure*, 239 Fed. 928.

In *Ohio Oil Company* v. *Indiana, supra,* this court said, speaking of oil and gas, "they have no fixed *situs* under a particular portion of the earth's surface within the area where they obtain. They have the power, as it were, of self-transmission", and are analogous to things *ferae naturae*. See also *Brown* v. *Vandergrift*, 80 Penn. St. 142, 147; *Westmoreland & Cambria Natural Gas Co.* v. *Dewitt*, 130 Penn. St. 235. See also *Stratton's Independence* v. *Howbert, supra.*

These decisions plainly hold, which is the fact, that although oil may be extracted from beneath the surface of one's property other oil may and does come into the property from that of others, thereby taking the place of the oil theretofore extracted, and that discovery may outrun depletion.

**The Respondent Did Not Purchase an "Oil Reserve" *of a Certain Number of Barrels of Oil,* as Contended by the Petitioner.**

This court has repeatedly held that there is no ownership of oil in the ground or "in place."

In *Ohio Oil Company* v. *Indiana, supra,* the facts were that the State of Indiana passed a statute making it unlawful for any person to permit the flow of gas or oil from any well into the open air for a longer period than two days next after the oil was struck. The State of Indiana filed a complaint against the Ohio Oil Company, stating that it had failed to confine the oil or gas in the manner required by the statute and asked that a writ of injunction issue. The Ohio Oil Company objected that the statute caused a taking of private property without adequate compensation. The decision turned on the point whether the owners of the surface owned the oil beneath. If they did, of course the State of Indiana could not interfere; if they did not the State had the right to conserve the common property. Mr. Justice White for the court held, page 208, that:

> "Although in virtue of his proprietorship the owner of the surface may bore wells for the purpose of extracting natural gas and oil, until these substances are actually reduced by him to possession, he has no title whatever to them as owner. That is, he has the exclusive right on his own land to seek to acquire them, but they do not become his property until the effort has resulted in dominion and control by actual possession."

And on page 209, the court said further concerning the rights of the owner of the well to oil and gas, that:

> "It being true as to both animals *ferae naturae* and gas and oil, therefore, that whilst the right to

> appropriate and become the owner exists, proprietorship does not take being until the particular subjects of the right become property by being reduced to actual possession."

The same is true under the laws of Oklahoma where these properties are situated. See *Rich* v. *Doneghey, supra.*

This court has reaffirmed and reiterated its decisions thereon in every case which has come before it since then, notably in *West* v. *Kansas Natural Gas Company,* and *Walls* v. *Midland Carbon Company,* (1920), *supra.*

Under the decisions of this court, therefore, the extraction of oil from a given property does not exhaust the capital thereof or the oil therein, a certain quantity of oil was not purchased, and an "oil reserve" of a certain number of barrels of oil was not acquired. The fugacious character of the oil, the fact that the owner of the land, or the lessee, has no title to the oil until it is reduced to dominion and control—actual possession,—the fact that there may be numerous strata under the surface which render oil and may be opened from time to time, and the fact that nature is always creating oil, render wholly untenable the position of the petitioner that the respondent purchased an "oil reserve" of a certain number of barrels of oil.

**The Grant by Congress of a Deduction for Depletion or Depreciation Which It Is not Required to Allow Does not Change the Character of the Proceeds From Income to Capital.**

This court has held that so-called depletion is income both under the Sixteenth Amendment and under the Revenue Acts of 1909 and 1913. *Stanton* v. *Baltic and Goldfield Consolidated Mining Co.* v. *Scott, supra.* Its fundamental nature is not changed because Congress, to provide suffi-

cient rewards for the operation of an extra-hazardous enterprise, to encourage the development of new producing properties, or for any other reason, in the abundance of its powers, has granted a deduction for the purpose of determining current taxable income from operations of some, but not all, years, which deduction it was not required to grant.

It was not until the Revenue Act of 1924, (Sec. 202 (b)), was enacted that there was any legislative provision that so-called depletion or depreciation should be deducted from the cost in order to determine the gain or loss on the sale of capital assets. There had theretofore been enacted five different Revenue Acts; those of 1909, 1913, 1916, 1916 as amended by the Revenue Act of 1917, and the Revenue Act of 1918, four of which were enacted after the passage of the 16th Amendment. The Treasury Department's practice had *not* been to require the reduction of the cost price by such allowances, because there is nothing in the Treasury regulations concerning this matter until the promulgation of Regulations 45, on *April 16, 1919*, which were subsequently changed several times. It is thus perfectly clear under the decisions of this court that Congress did not contemplate the reduction of cost by amounts for depletion or depreciation under any of the Revenue Acts prior to that of 1924. *United States* v. *Field*, 255 U. S. 257; *Smietanka* v. *First Trust & Savings Bank*, 257 U. S. 602.

In the latter case this court, in disposing of the government's contention for the application of the provisions of a later act to taxes of earlier years, stated on page 606:

> "This seems to us to graft something on the statute that is not there. It is an amendment and

not a construction, and such an amendment was made in subsequent income tax laws * * *."

These decisions were followed in the case of ***U. S. v. Merriam***, 263 U. S. 179, 187, wherein the court said:

> "On behalf of the Government it is urged that taxation is a practical matter and concerns itself with the substance of the thing upon which the tax is imposed rather than with legal forms or expressions. But in statutes levying taxes the literal meaning of the words employed is most important, for such statutes are not to be extended by implication beyond the clear import of the language used. If the words are doubtful, the doubt must be resolved against the Government and in favor of the taxpayer. Gould *v.* Gould, 245 U. S. 151, 153. The rule is stated by Lord Cairns in Partington *v.* Attorney-General, L. R. 4 H. L. 100, 122."

Counsel submits that to increase the taxable income in this case by any amount for so-called depletion or depreciation of earlier years would be to graft something on the statute which is clearly not there and not contemplated, that the provisions of the Revenue Acts may not be extended by reading into them a construction which is not apparent, that revenue acts are to be strictly construed and that they are not to be extended by implication. Therefore, it is clear no reduction should be made in the cost price in the case at bar.

***Holmes on Federal Taxes, 1923 Edition***, page 501 dealing with this precise question is to the same effect:

> "In computing the gain derived or loss sustained upon a sale or exchange of property for property (in cases in which an exchange results in recog-

nizable gain or loss) the treasury department has ruled that there should be subtracted from cost, or added to selling price (it is immaterial which is done, since in both cases the gain is increased or the loss is reduced, as the case may be), any depreciation or depletion sustained and allowable as a deduction in computing net income with respect to the property sold or exchanged. * * * This ruling is without express statutory basis; neither the Revenue Act of 1921 nor any of the previous laws specifically provided that in computing taxable gain or deductible loss there should be any adjustment for depreciation or depletion. *There is much to be said for the theory that where a statute specifically and in detail provides a basis for determining gain derived or loss sustained upon a sale or exchange of property, modifications of that basis should not be read by implication into the statute. The requirement of the department that an adjustment should be made for depreciation or depletion has the effect of nullifying the provisions of the statute permitting annual deductions for depreciation. Its result is to throw into income in one year (the year of sale or exchange) the total of the amounts deducted as depreciation or depletion in several years.*"

Holmes' last work, 1925, page 702, is to the same effect.

**The Petitioner Errs in Considering the Purchase, *Operation*, and Sale as Being One Transaction. There Was an Actual Loss.**

The transaction here involved is the *sale* of certain property *during the year 1917*. The question before the court is what gain or loss if any resulted from *that sale*. Therefore, we are not concerned with the profits or gains derived annually through the *operation or use* of the prop-

erty during ownership. Those profits were properly accounted for in the taxpayer's annual income tax returns for the years in which such profits were received. To illustrate with a simple case, if a taxpayer purchased an automobile in 1915 for $2,000 and sold it in 1917 for $1,000 he sustained a loss on *the sale* notwithstanding he may have made a net profit of $3,000 by *using* the car in a taxicab business during the year 1916. The profit of $3,000 was derived from an entirely separate and distinct transaction—operation or use of the car during the year 1916—and has no bearing whatsoever on the loss sustained on the sale of the car in the year 1917. The petitioner adds to the sale price part of the receipts from operation arising between the date of purchase to the date of sale. The profit derived from the *operation or use* of the property is not a factor entering into the proper determination of gain or loss on the *sale* of the property. We are not concerned with the *operation* of an oil property *i. e.*, the removal and sale of oil. What we are concerned with is the result in gain or loss arising from the sale of fees and leases. Gain may be derived from the *operation* of oil lands, but that gain is income and is of no moment here for it results from an entirely different transaction and involves other questions not material in the present issue.

The petitioner on page 13 of his brief cites the example of a man buying a "lease in 1914 for $10,000, extracting and selling at a cost of $5,000 all the oil, for which $25,000 is received; then selling the lease for $5.00; and then taking as a deduction *against the profit from the sale of the oil*" the difference between cost and sale price. This is thaumaturgy which counsel for the respondent cannot understand, unless the lease were sold in the year in which bought, and if that

is the case, the deduction for the difference between the cost and sales price was correct. If, however, the lease were sold in a year subsequent to 1914, as in the example, how could the loss be taken "against the profit from the sale of the oil" in earlier years? It could not; the profits from the sale of the oil would have been taxed annually as earned according to the statutes in effect at that time. In the instant case the respondent does not seek to offset in any manner the profit derived from the sale of oil. The respondent made his returns and paid his income taxes annually on his profits from the sale of oil. He makes no contention that those profits were overstated or excessively taxed and he seeks no adjustment in that connection. He is now concerned solely with the profit—or loss—resulting from the sale of the properties in 1917.

The property was sold for less than it cost. There was therefore a loss from the sale of property. Such loss was an actual loss and a proper deduction from income calculated in accordance with this court's opinions in the cases of *U. S.* v. *Flannery*, 268 U. S. 98; and *McCaughn* v. *Ludington*, 268 U. S. 106.

**The character of the property did not change between the date of purchase and the date of sale, but even if it had changed, that would not affect the fact of gain or loss.**

The parties on this point stand on fundamentally different grounds. The government's position is that both depletion and depreciation change the *character* of property. The taxpayer denies that either depletion or depreciation works any change in the *character* of property.

The parties, of course, are in agreement that gain or loss is the difference between the cost (or value) and the

sales price of a particular property, for obviously the gain or loss on the sale of one certain property cannot be determined by comparing its cost or sales price with the cost or sales price of a different property. There is no disputing that the cost of a given quantity of oil cannot be compared with the sales price of a lesser quantity of oil to determine the gain or loss on a sale of the latter; or that the cost of a lot with a new house on it cannot be compared with the sales price of the lot alone to determine gain or loss on the sale of the lot. But these illustrations in the petitioner's brief throw no light on the issue presented in the instant case, for they are not at all analogous.

We are not here dealing with a purchase and sale of a given quantity of oil or of oil in reservoirs or tanks. We are dealing with fees and leaseholds of oil producing lands (R. 11). Such property does not change in character by mere operation or use. The extraction of oil from the lands does not change the character of the fee or the lease. And ordinary wear and tear on machinery does not change the character of the machinery. The extraction of the oil (so-called depletion) and the wear and tear (so-called depreciation) may or may not result in a diminution of market value of the properties, but the nature and character of the properties remain the same.

The fees and leases purchased by the respondent gave him the exclusive right to prospect for and reduce to possession whatever oil might be found within the limits of the properties. How large or small the quantity of that oil might be was beyond the limits of human knowledge. There is no finding of fact as to the quantity of oil recoverable from the lands here in question, as indeed there could not be from the very nature of the thing. The respondent could

not have purchased an oil reserve of certain content as the petitioner suggests, because no one could know what oil, if any, might be recovered and no one could give him title to such an "oil reserve", because no one had title. The phrase, "oil reserve", properly refers to the character of the property, the right to take whatever oil may be obtained from it; it does not refer to or describe an inert body of oil of unchanging quantity except as lessened by extraction. The respondent did not purchase oil in a tank or reservoir. When the properties were purchased there may have been only 5,000 barrels under the surface, but, upon bringing in a well, 500,000 barrels may have been drawn from other properties.

There is, therefore, no foundation for the argument that the increase in the value of unextracted oil cannot be ascertained by comparing the total cost of the "oil reserve" as it existed at the time of purchase with the price obtained for that part of it remaining at the time of the sale.

The character or kind of property purchased and sold, we reiterate, consisted of fees and leaseholds. The respondent had the exclusive and unrestricted right to prospect for and reduce to possession at any and all times any oil that could be extracted from such lands. This right remained constant in character notwithstanding the removal of oil. Its value may have changed but its nature, its character, remained the same. The removal of oil worked no change in the "extent" of the property purchased. Oil was the fruit of the property and not the property itself, and the proceeds of the sale of the oil represented *gains, profits and income derived from capital* and not capital itself. As a tree bears fruit and, after the fruit is gone, remains to bear further fruit, the extent of which is unknown, so in the

present case the property bears oil and yet remains itself intact to bear further oil.

Manifestly, the receipt of income from capital does not work a change in the character of the capital; and it is contradictory to say that the receipt of income *derived* from capital constitutes a return of that capital.

**The taxpayer is not now trying to recoup in the year 1917 losses of earlier years.**

In the findings of fact which were stipulated by the parties (R. 12, Finding V), it is shown that the respondent deducted from his income tax returns for the year 1913, 1914, 1915 and 1916 on account of so-called depletion and depreciation the aggregate sum of $5,156, as against the aggregate sum of $43,110.47, alleged by the Commissioner of Internal Revenue to have been sustained.

The petitioner in its brief at page 22 says:

> "The taxpayer in this case under the applicable Act was entitled to recover $10,465.16 of his capital investment by way of depreciation allowances in 1913, 1914, 1915, 1916 and 1917. During the same period he was entitled to recover some part of $32,253.81 by way of depletion allowances. For some reason he did not claim such deductions in those years. He does not now seek to do so. But he here says that because he did not take advantage of the right given him by statute he can recover his total capital investment from the income of a later year. Further, he delegates to himself the right to choose the year in which he shall have the benefit. In other words, he claims that he is entitled to recoup from taxable income in the year 1917 a loss, which, had he availed himself of his statutory rights, would not have been suffered."

But on page 18 of the brief it is said it is immaterial, "that the taxpayer has not deducted or been permitted to deduct the cost of property previously sold."

Suffice it to say that the found facts are that the taxpayer respondent, who operated the properties, deemed that he had sustained depletion in the four years under consideration in an amount less than the amount which the Commissioner of Internal Revenue, according to his method of calculation, considered respondent to have suffered. It might well be urged that the respondent was more capable of determining so-called depletion and depreciation on the ground where the properties were than the Commissioner of Internal Revenue in Washington. The fact of the matter is that the respondent is not seeking, as the Solicitor General states, to recover his total capital investment from income of a later year, because no matter how the calculation is made it has abundantly been shown he suffered no capital losses by depletion and depreciation.

**The decision of the Court of Claims does not permit a double deduction. The petitioner would deny a deduction granted by Congress and mulct the respondent in a year of higher rates.**

The government has *assumed* that so-called depletion and depreciation are actually a return of capital. Counsel submits it has repeatedly been shown that depletion and depreciation are not a return of capital. The taxpayer's gains in each year were accounted for in the year in which earned and a tax thereon was paid in accordance with the Revenue Acts in effect at that time. The only deduction taken for all these years was the sum of $5,156.00.

The decision of the Court of Claims grants to the respondent that which Congress has clearly given him and

prevents the Commissioner of Internal Revenue denying to him the deduction expressly allowed by Congress. In other words, the Commissioner in requiring the taxpayer to reduce his cost by the amount of the depletion and depreciation deduction granted by Congress, allows these annual deductions only *in case the asset is not sold.* If the asset is sold, the Commissioner deprives the taxpayer of this deduction by increasing his profit by the amount which Congress has said he may deduct from his income and forces him to pay a tax all in one year, at higher rates, on income earned over a period of years which was returned and taxed in accordance with the laws in effect for those years.

**Doyle v. Mitchell Brothers Company, 247 U. S. 179.**

The petitioner's brief on page 21, under subdivision 3, states,

> "The reason that cost or March 1, 1913, value is deducted from the sales price in determining gain or loss is to restore to the taxpayer his capital investment tax-free."

and cites *Doyle* v. *Mitchell Brothers Company, supra.* This Court decided that case on May 20, 1918, and in its opinion specifically limited it to the facts therein considered, namely, timber and acreage, saying, at page 188:

> "There is only a superficial analogy between this case and the case of an allowance claimed for depreciation of a mining property through the removal of minerals, since we have held that owing to the peculiar nature of mining property its partial exhaustion attributable to the removal of ores cannot be regarded as depreciation within the meaning of

> the act. *Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503, 520, 524; *United States* v. *Biwabik Mining Co., ante*, 116; *Goldfield Consolidated Mines Co.* v. *Scott, ante*, 126."

On the same day the opinion in the *Mitchell Brothers* case was handed down the Court rendered its decision in the case of *Goldfield Consolidated Mines Company* v. *Scott, supra*, in which it specifically and unequivocally held that a mining corporation was not entitled to deduct "*any amount whatever*" on account of depletion or exhaustion of the ore bodies caused by its operations for the year for which the tax was assessed, and that there should not be allowed even a deduction from the gross proceeds from the mining and treatment of ores *to the extent of the cost value* of the ore in the ground before it was mined, ascertained in strict compliance with the rules and regulations of the Treasury Department. Counsel submits that the case of *Doyle* v. *Mitchell Brothers Company* is peculiar to itself.

**Discussion of the petitioner's contentions regarding depreciation.**

The government argues that depreciation (ordinary wear and tear) works a change in the *character* of property. This proposition we believe to be unsound. It seems to us that a building remains a building for all of depreciation. It may be a new building when bought and an old building when sold but nevertheless it is a building. True it is that the *value* may have lessened by the passage of time and by the ordinary wear and tear incident to use or caused by the elements. But a change in value is manifestly not a change in character.

If a building has depreciated in value through wear and tear, exhaustion or what not, or has enhanced in value for any reason whatsoever, these changes in value will be reflected in the sales price. If an increment in value due to economic causes is more than sufficient to offset the effects of wear and tear, a gain results—otherwise the effects of wear and tear reduce the market value and this reduction being reflected in the sales price, a loss results.

The petitioner in discussing this subject says on page 20,

> "While the depreciation was 'covered in the sale price', it was not 'covered in the cost'."

It is certain that depreciation would not be covered in the cost if the asset were new, there would have been no depreciation; and in the case of the sale after use, it is impossible to conceive of a purchaser buying without taking into account its then condition, which would of course comprehend depreciation.

The essential fact is that in order to determine the extent of depreciation *it is necessary* to compare the value of the property *new* or at the time acquired with the value of the property at any later date as the courts have held. *Nashville C. St. L. Ry. Co.* v. *U. S.*, 269 Fed. 351; certiorari denied, 255 U. S. 569.

Increment in value due to other causes may offset the depreciation due to wear and tear. We see nothing in *La Belle Iron Works* v. *U. S.*, 256 U. S. 377, contrary to this view.

The decision of the Board of Tax Appeals in the Appeal of Even Realty Company cited by the Solicitor General is in direct conflict with the decision of the United States District Court for the Northern District of Texas in the

case of *Ward, et al.* v. *Hopkins.* (U. S. Tax Cases 1571, not otherwise reported.) The Board's decision starts with the same false premise as does the petitioner, that depreciation is a return of capital, whereas it has been abundantly shown that it is not. In the Ward case the court held directly that in determining profit upon the sale of capital assets, depreciation sustained—whether or not deducted in computing income—should not enter into the computation.

We can see no support for the Government's contention in the two other cases which the Solicitor General cites, namely, *Henrici Company* v. *Reinecke*, 3 F. (2nd) 34; and *Kaufman-Straus* v. *Lucas*, 12 F. (2nd) 774.

**The basis should not be reduced by any amount.**

The proceeds of mining operations do not constitute a return of capital in whole or in part, but are income, and Congress was not required to make an allowance for depletion in computing annual net income from operations. *Goldfield Consolidated Mines Company* v. *Scott; Stratton's Independence* v. *Howbert; Stanton* v. *Baltic Mining Company; Commonwealth* v. *Ocean Oil Co., supra.* The mere fact that Congress, in the abundance of its powers, permitted in certain years, but not in all years, a limited deduction from annual gross income, which it was not required to make, on account of so-called depletion, does not change the character of the proceeds derived from the operation of oil properties. These proceeds, notwithstanding the allowance of a deduction, continue to represent earnings,—income. And a provision of Congress omitting in certain years to tax all or a part of these proceeds does not make them a return of capital.

The allowance granted by Congress for depletion was not and did not purport to be a return of capital. This is clearly shown by the earlier Acts and by the allowance of depletion based on discovery value in the later Acts. Cost represents capital and must be deducted in determining gain. Depletion represents not capital, but income, and therefore need not be deducted from the cost in determining gain on the sale of the fee. An allowance for depletion is merely the declination of Congress to tax all the income from mining or oil operations. It still remains an earning.

## Conclusion.

**The judgment of the Court of Claims should be affirmed.**

Respectfully submitted,

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